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Department of the Treasury

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Date: July 26, 2010

LEGEND

Taxpayer =

Company =

Business Entity =

Predecessor =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

Year 3 =

Time Period =

Bank =

\$x =

a =

b =

C =

A =

E =

D =

Dear :

This letter responds to your letter postmarked January 27, 2010 requesting certain rulings on behalf of Taxpayer, d/b/a Company, concerning the application of various sections of the Internal Revenue Code to transfers made by Taxpayer to various escrow accounts. By letter postmarked June 3, 2010, the administrator of the escrow accounts joined Taxpayer's request for these rulings.

FACTS

Taxpayer is the sole owner of Company, a Business Entity that develops, manufactures, advertises, markets, sells and distributes a products, including b. Taxpayer uses an accrual method of accounting and a taxable year that ends on December 31. Taxpayer's Year 3 tax return was filed in Date 4.

The Cs filed suit against the major manufacturers of a products. The suits sought monetary, equitable, and injunctive relief under various laws, including consumer protection and/or antitrust laws. Taxpayer was not a party defendant in this lawsuit.

On Date 1, the Cs entered into a settlement agreement, A, to resolve litigation against the major manufacturers of a products. Under the A, the party defendant manufacturers of b and other a products are required to establish escrow accounts and make annual payments into escrow for the benefit of the Cs. The party defendants' ongoing payments to the escrow accounts are determined based on their sales of b. In exchange for these payments, the A releases the defendant manufacturers from all past, present, and certain future claims stemming from the use, sale, distribution, manufacture, development, advertising, or marketing of b. Under the A, these escrow accounts are intended to be treated as qualified settlement funds for federal income tax purposes.

The party defendant manufacturers contended, and the Cs agreed, that the manufacturers of a products not named as party defendants in litigation should be required to make annual contributions similar to those required of the party defendants. Accordingly, the A directs the Cs to require that certain nonparty manufacturers, of which Taxpayer is one, either abide by the terms of the A or establish escrow accounts and make contributions thereto for the benefit of the Cs. Nonparty manufacturers who do not elect to abide by the terms of the A are referred to as “non-participating manufacturers.” Accordingly, each C has enacted E that requires non-participating manufacturers to make annual deposits into escrow accounts for the benefit of the C, to the extent the non-participating manufacturer’s a products were sold in the C.

The E is identical or substantially similar to a D attached to the A. According to the D, the financial burdens created by the use of b should be borne by the a manufacturers rather than by the Cs. The amount of a non-participating manufacturer’s annual deposits into the escrow accounts required by the D is based on the manufacturer’s sales of b within a C during the year in question. The escrowed funds may be used only to satisfy claims arising from the manufacture, sale, etc. of b by the nonparticipating manufacturer. Any funds that remain in the escrow after Time Period from the day on which they were contributed will be refunded to the non-participating manufacturer.

Pursuant to the D, the Cs may use civil litigation to enforce the escrow contribution requirement. In addition to ordering a non-compliant non-participating manufacturer to make the required contribution, a court may impose civil penalties. In certain cases the non-participating manufacturer may be prohibited from selling b in the Cs for up to a two-year period.

Predecessor was the sole owner of Company until Date 2. On that day, Taxpayer purchased Company. Predecessor was a non-participating manufacturer, and Taxpayer is a non-participating manufacturer. Thus, pursuant to E, Predecessor and Taxpayer are required to establish escrow accounts to the extent they sold b within a C.

During Year 1, Predecessor entered into an escrow agreement with Bank. The escrow agreement sets forth terms and conditions relating to the contributions required by the legislation enacted by the Cs pursuant to the A. During Year 2, after Taxpayer purchased Company, the escrow agreement was amended to reflect Taxpayer’s ownership of the business. As of Date 3, Taxpayer has deposited a total of \$x into the escrow accounts.

Taxpayer expects that the Cs in which Taxpayer does business will make claims against Taxpayer, that all of the contributed funds will be used to satisfy the Cs’ claims if the claims are successful, and accordingly, that Taxpayer will not receive a refund of

any of the contributed funds. This expectation is based on Taxpayer's belief that the Cs' will be as successful with respect to Taxpayer as with the defendant manufacturers.

REQUESTED RULINGS

Escrow Account Classification

The first requested ruling is that the escrow account established pursuant to the A with Bank is a qualified settlement fund within the meaning of § 1.468B-1 of the Income Tax Regulations.

Section 468B(g) provides, in part, that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. Pursuant to the authority of section 468B(g), the Secretary has published §§ 1.468B-1 through 1.468B-5 regarding qualified settlement funds.

Section 1.468B-1(a) provides that a qualified settlement fund is a fund, account, or trust that satisfies the requirements of § 1.468B-1(c). First, § 1.468B-1(c)(1) requires that the fund, account, or trust is established pursuant to an order of, or it is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continued jurisdiction of that governmental authority. Second, § 1.468B-1(c)(2) requires that the fund, account, or trust is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability (i) under the Comprehensive Environmental Response, Compensation and Liability Act of 1980; (ii) arising out of a tort, breach of contract, or violation of law; or (iii) designated by the Commissioner in a revenue ruling or revenue procedure. Third, § 1.468B-1(c)(3) provides that the fund, account, or trust must be a trust under applicable state law, or its assets must be otherwise segregated from other assets of the transferor (and related persons).

Section 1.468B-1(j)(1) provides that if a fund, account, or trust is established to resolve or satisfy claims described in § 1.468B-1(c)(2), the assets of the fund, account, or trust are treated as owned by the transferor of those assets until the fund, account, or trust also meets the requirements of § 1.468B-1(c)(1) and (c)(3). On the date the fund, account, or trust satisfies all the requirements of § 1.468B-1(c), the transferor is treated as transferring the assets to a qualified settlement fund.

Section 1.468B-2(k)(2) provides that a qualified settlement fund is in existence for the period that (i) begins on the first date on which the fund is treated as a qualified settlement fund under § 1.468B-1; and (ii) ends on the earlier of the date the fund (A) no longer satisfies the requirements of § 1.468B-1; or (B) no longer has any assets and will not receive any more transfers.

Based on the facts represented, in Year 1, the escrow accounts established by Predecessor satisfied all three requirements of § 1.468B-1(c), and therefore are treated as qualified settlement funds as of the date established.

First, with respect to § 1.468B-1(c)(1), the escrow accounts are established pursuant to an order of a C, and are subject to the continuing jurisdiction of such C. The Cs, which are governmental authorities under § 1.468B-1(c)(1), enacted E requiring Taxpayer (and Predecessor) to make contributions into escrow accounts. Pursuant to this legislation, Taxpayer must annually certify to the Cs that Taxpayer is in compliance. The appropriate official of each C has the authority to monitor Taxpayer to enforce annual compliance with the state's legislation by pursuing civil litigation, imposing penalties, or restricting Taxpayer's ability to sell b in the settling jurisdiction.

Second, with respect to § 1.468B-1(c)(2), we are persuaded that the escrow accounts were established to resolve or satisfy contested or uncontested claims that have resulted or may result from a related series of events that have occurred and that have given rise to at least one claim asserting liability arising out of a violation of law.

The event (or related series of events) that has already occurred is the manufacturing and distribution of a products, including b, by Taxpayer. The claim that has already arisen is that pursuant to the E, a manufacturer of a products is financially liable to reimburse the Cs for the costs associated with the harms allegedly related to the sale of b. This liability arises from alleged violations of various state laws by the nonparticipating manufacturers. Although no C has filed a formal complaint against Taxpayer, the regulation requires only that at least one "claim" asserting liability has resulted or may result.

It is clear that the escrow accounts were established to resolve or satisfy the claims made by the Cs. The E forces nonparticipating manufacturers to assume a share of the financial burdens created by the harms allegedly caused by the use of b. The legislation requires any nonparticipating manufacturer selling b within the C to make annual deposits into escrow accounts, for the benefit of the C. The amounts of a nonparticipating manufacturer's deposits are based on the manufacturer's sales of b during the year in question. Taxpayer is a nonparticipating manufacturer, and the amounts of Taxpayer's deposits are calculated on this basis in order to compensate the Cs.

Third, with respect to § 1.468B-1(c)(3), the contributed funds are physically segregated from other assets of Taxpayer (and related persons). The contributed funds are held in accounts separate from other assets. Under the regulations, a separate bank account is sufficient to satisfy this requirement. See § 1.468B-1(h)(1).

Deduction for Payments to Escrow Accounts

The second requested ruling is that the payments made by Taxpayer to the escrow accounts in Year 3 are deductible in Year 3, and payments made by Taxpayer to the escrow accounts after Year 3 are deductible in the year deposited into the accounts. Section 162(a) of the Code provides the general rule that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See also § 1.162-1(a).

Section 461(a) provides, in part, that a deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) provides, in part, that under an accrual method of accounting, a liability is incurred, and generally taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(f) provides that if (1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of § 461(h), then the deduction shall be allowed for the taxable year of the transfer.

Section 461(h)(1) provides, in part, that in determining whether an amount has been incurred with respect to any item during a taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 461(h)(4) provides that the all events test is met with respect to any item if all events have occurred which determine the fact of the liability and the amount of such liability can be determined with reasonable accuracy.

Section 1.468B-3(c)(1) provides that for purposes of § 461(h), economic performance occurs with respect to a liability described in § 1.468B-1(c)(2) to the extent the transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability.

Section 1.468B-3(c)(2) provides that economic performance does not occur to the extent (A) the transferor (or a related person) has a right to a refund or reversion of a transfer if that right is exercisable currently and without the agreement of an unrelated

person that is independent or has an adverse interest (e.g., the court or agency that approved the fund, or the fund claimants), or (B) money or property is transferred under conditions that allow its refund or reversion by reason of the occurrence of an event that is certain to occur, such as the passage of time, or if restrictions on its refund or reversion are illusory.

Section 1.468B-3(f)(1) provides that a transferor must include in gross income any distribution it receives from a qualified settlement fund.

Section 1.468B-3(f)(3) provides that a distribution described in § 1.468B-3(f)(1) or (f)(2) is excluded from the gross income of a transferor to the extent provided by § 111(a) (regarding the recovery of tax benefit items).

Based on the facts represented, the amounts transferred into escrow accounts will be used to pay money damages to the Cs for liabilities that arose as a result of Taxpayer's principal business activity, that is, the manufacture and sale of b and other a products. Thus, such amounts are deductible under § 162(a) as ordinary and necessary business expenses. To the extent that the all events tests under § 1.461-1(a)(2), including economic performance, are met, the amounts transferred into the escrow accounts would be deductible in the taxable year transferred. In this case, the first prong of the all events test, i.e., all the events have occurred that establish the fact of the liability, is met because this is a contested liability within the meaning of § 461(f). Likewise, the second prong, i.e., the amount of the liability can be determined with reasonable accuracy, is met because the amount of the liability can be readily ascertained based on the formula prescribed by the D and the E. Finally, under § 1.468B-3(c), transfers to a qualified settlement fund to resolve or satisfy claims for which it is established constitute economic performance.

In addition, under the facts presented and representations made, the fact that the D and the E provide for a reversion of monies if any remain after Time Period from the date of the transfers does not prevent economic performance from occurring. The D provides that the monies transferred into the escrow accounts revert to Taxpayer after Time Period from the date of the transfers if the Cs have not filed and prevailed on claims either by obtaining a judgment against, or a settlement with, Taxpayer. The funds exist to satisfy the Cs' claims brought against Taxpayer within Time Period after the date monies are transferred into the funds. Thus, Taxpayer may not access the funds for any purpose other than satisfying the Cs' claims during the Time Period. Taxpayer expects that claims will be made against all the assets of the funds and, if successful, the funds will be used to satisfy the Cs' claims and that nothing will remain to revert to Taxpayer. There is no guarantee that any amounts will revert to Taxpayer after Time Period. The reversion in this case requires not only the passage of time, but also the successful defense against claims brought by the Cs before anything reverts to Taxpayer. Although the passage of time (i.e., Time Period) is certain to occur, it is

clearly uncertain whether the Cs will neither file nor prevail on claims against Taxpayer. Thus, the payments are not transferred under conditions that allow their refund or reversion by reason of the occurrence of an event that is certain to occur. Finally, Taxpayer does not have a currently exercisable right to a refund or reversion.

Therefore, we conclude that the payments made by Taxpayer to the escrow accounts in escrow accounts in Year 3 are deductible in Year 3, and payments made by Taxpayer to the escrow accounts after Year 3 are deductible in the year deposited into the accounts. However, to the extent Taxpayer receives any distributions from the escrow accounts, e.g., overpayments, refunds, interest, or other appreciation on the funds, Taxpayer must include such amounts in its gross income.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer's authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

MARTIN SCULLY, JR.

Martin Scully, Jr.
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